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Tax Advantages of Foundations and Exempt Organizations

*by Joseph Berman and Daniel S. Berman,
Members of New York and Federal Bars*

BUSINESSMEN THESE DAYS are playing an ever increasing role in the creation and support of "non-profit" philanthropic foundations. Their purpose is a dual one; to save taxes and to immortalize a family name, and they are as old as the pyramids. We know of about 20,000 foundations existing in England, but the large broad-purpose foundations were created in the United States.

In 1930 there were less than 250 foundations in the United States. We have now about 5,000 foundations with \$3.2 billion in assets and a yearly outlay of about \$150 million.

The greatest expansion in this area is attributable to the family and corporate foundations. The corporation tax of 52% and the individual income tax of up to 91% are so severe that high-bracket taxpayers can give to charity at a small cost.

Foundations are quite new as a business device and their range has barely been touched. The trend is towards more participation by business toward more foundations and less wealth for each foundation.

The uses and advantages of foundations are delimited mainly by the tax laws. The Revenue Act of 1950 has practically killed the foundation as a profit-making business device but we cannot foretell what the future may bring. The role that foundations play in our economy will be decided on what is best for the public interest.

A foundation is "any independent, non-profit, legal entity set up to serve the welfare of mankind." It administers wealth that is transferred to it through tax-free gifts or bequests. It can earn tax-free profits through investment or activities related to its specified purposes. Since 1950 it cannot get into unrelated fields to make profits, otherwise it will have to pay taxes on such income.

There are no "typical" foundations; they are the "least stereotyped of all the organizations in our country."

They are created for these reasons:

1. To systematize the charity contributions they would make anyway.

2. To make a greater play for local and national good will by consolidating and expanding their contributions.

3. To encourage research in their own industry, the training of technicians needed by their industry or merely to back research or cultural projects that benefit the general public.

4. In the case of closely held corporations to maintain the family's control of a company by giving much of the stock to a foundation instead of having to sell it publicly in order to pay inheritance taxes.

5. To perpetuate themselves as institutions by transferring ownership entirely to a foundation.

6. Most importantly, *to save taxes on profits and inheritance taxes for their major owners from the public domain to independent organizations.*

The controlling interest of the corporation is transferred to a non-profit foundation. The foundation does not replace the corporation, it takes the place of the majority stockholder. Its board of trustees is synonymous with the board of directors of the corporation; as its membership changes, so does the board of directors—until finally the business may be run by people who are not answerable in any way to the other stockholders.

As a stockholder, the foundation wants earnings from its shares in order to carry on its philanthropic function. Ordinarily it doesn't feel the same urgency for dividends that individual stockholders feel. This may cause friction in the management of a business.

Since they are established in the public interest and mainly financed by tax-exempt money, the public has a large stake in foundations. Nevertheless, it has little or no direct control.

As more corporate profits are distributed tax-free to foundations—up to the limit of 5% of profits—the government will have to find new sources of revenue.

Our earlier foundations were established by our great family fortunes—the Carnegie, Rockefeller and Ford foundations, etc., which aided our public libraries, medical schools, attacked yellow fever and hookworm. The new foundations are less spectacular and are confined to smaller areas of support and exploration, as interracial problems, education methods, and foreign technical aid. The present trend is towards increasing scrutiny by the

public which now holds a life-or-death verdict over most foundations.

Organizations which are not organized or operated principally for profit are granted exemption from all taxes on income, including the excess profits tax imposed by the Internal Revenue Code.¹ Formerly the exemption applied to all income received, including interest on U. S. Savings Bonds;² there are now a group of organizations which are subject to income tax on certain parts of their revenue and exempt for all other purposes.

In order that it may have tax exemption, the organization must fall within one of the exempt classes, and unless the law specifically provides to the contrary, it applies to foreign as well as to domestic corporations.³

The exempt corporations include these:

Labor, agricultural and horticultural organizations.

Fraternal beneficiary societies.

Credit unions and certain non-profit corporations organized before September 1, 1951, as auxiliaries to the formerly exempt mutual savings banks, cooperative banks, and domestic building and loan associations.

Cemetery companies.

Religious, charitable, educational, literary and scientific corporations, funds and foundations and organizations for the prevention of cruelty to children or animals.

Business leagues and chambers of commerce, real estate boards and boards of trade.

Civic organizations and local associations of employees.

Social Clubs.

Local benevolent life insurance associations and mutual irrigation and telephone companies.

Mutual insurance companies other than life or marine, such as hail, cyclone or fire insurance organizations.

Farmers' cooperative marketing and producing organizations, subject however to an exception with respect to their unallocated reserves.

Corporations organized to finance crop organizations.

Corporations organized exclusively to hold property and turn over income to exempt corporations.

¹ Sec. 101.

² I. T. 3499, CB 1941-2, 78.

³ I. T. 1399, CB I-2, 167 (1922).

Corporate instrumentalities of the United States.
Voluntary employees' beneficiary associations.
Local teachers' retirement fund associations.
Religious or apostolic organizations.⁴

Organizations which register or are ordered to register after investigation by the Board under the Internal Security Act of 1950 are not entitled to exemption and contributions to such organizations are not deductible.⁵ Trusts created for charitable, scientific and similarly privileged purposes may lose their exemption through prohibited dealings with the person who created them, or through improper accumulation.⁶ Organizations operated for the primary purpose of carrying on a trade or business cannot (for taxable years beginning after 1950) claim exemption on the ground that they turn all their net earnings over to an exempt organization.

Mutual savings banks, cooperative banks, and domestic building and loan associations were exempt for taxable years beginning before 1952.

Exempt organizations are not relieved because of their exemption from the employers' duty to withhold part of their employees' compensation as taxes on the employees' income.

In order to qualify as exempt, an organization must fall precisely within the terms of the statute. Statutes granting exemptions are strictly construed⁷ and any doubts in construction are generally resolved against the taxpayer. The taxpayer has the burden of showing that it clearly comes within "the exemption."⁸

Most important in determining the exempt status of an organization are its articles of incorporation, its constitution and by-laws. They must not only provide the powers and purposes necessary to qualify the organization as an exempt corporation but must also provide them to the exclusion of others.⁹ Additional powers, although never exercised, granted by its charter will serve to deny exemption to a corporation.¹⁰ The opposite conclusion was reached, however, where dividends could have been paid by an organization except for a stockholders' resolution

⁴ Sec. 501 (1954 I. R. C.).

⁵ Sec. 11, P. L. 831, 9/23/1950.

⁶ Sec. 503 I. R. C.; Sec. 504 I. R. C.

⁷ *Sun-Herald Corp. v. Duggan*, 73 F. (2d) 298, cert. den. 294 U. S. 719.

⁸ *New York Trust Co. v. U. S.*, 63 Ct. Cl. 100.

⁹ *S. M.* 2941, CB IV-1, 210 (1925).

¹⁰ See note 7 *supra*.

passed soon after incorporation which specifically provided that no dividends be paid on stock and none were in fact paid.¹¹

On the other hand, the charter, constitution and by-laws of an organization will not be controlling if the organization actually carries on business operations beyond their provisions. Thus, a corporation will not be granted exemption merely because it is organized under a state law relating to non-profit corporations if its actual operations indicate that profit is contemplated.¹²

In *Sebastian-Lathe Co. v. Johnson*¹³ a business corporation amended its charter during a taxable year to make it a charitable organization. For purposes of a tax due on non-exempt corporations at the beginning of a taxable year, the amendment did not provide exemption.

*Kyron Foundation, Inc. v. Dunlap*¹⁴ held that "No declamatory judgment can be had on exempt status."

In *John Dunz* case,¹⁵ where a deficiency notice was sent before September 20, 1950, the Court held that taxpayer came within limitation period.

The Service is no longer giving rulings to tax-exempt organizations on the basis of a short tax year. It would require a full 12-month experience before ruling.

In order to obtain exemption, a questionnaire or an affidavit must be filed with the collector for the district in which is located the organization's principal office or place of business. Questionnaire forms must be filed by:

1. Form 1023 by religious, charitable, scientific organizations, etc.
2. Form 1024 by labor and agricultural organizations, fraternal, beneficiary, business leagues and civic leagues.
3. Form 1025 by social clubs.
4. Form 1026 by local benevolent life insurance companies, corporations holding property of exempt organizations, voluntary employees' beneficiary associations.
5. Form 1028 by farmers' cooperatives.

All other organizations, including bona fide credit unions,

¹¹ I. T. 2325, CB V-2, 63 (1926).

¹² *Apartment Operators Assn.*, 46 BTA 229, aff'd. 136 F. (2d) 435.

¹³ 110 F. Supp. 245.

¹⁴ 110 F. Supp. 248.

¹⁵ 18 T. C. 454 (A).

claiming exemption, should file with the District Director an affidavit showing:

- (a) The character of the organization.
- (b) The purpose for which it was organized.
- (c) Its actual activities.
- (d) The source of its income and distribution.
- (e) Whether or not any of its income is credited to surplus or may inure to the benefit of any private shareholder or individual.
- (f) In general, all facts relating to the operation which might affect its right to exemption.

To the questionnaire or affidavit should be attached a copy of its charter, articles of incorporation, declaration of trust, or similar instrument, setting forth the permitted powers and activities of the organization, the by-laws and the latest financial statement showing the assets, liabilities, receipts and disbursements. The Commissioner may also require any additional information he deems necessary to determine the status of a particular organization.¹⁶

The District Directors, in uninvolved cases, shall decide whether or not the corporation is exempt. In complicated situations the case shall be forwarded to the National office for a ruling. Directors must keep a list of all exempt organizations and check occasionally to find out whether or not they are observing the conditions upon which exemption is based.

The Commissioner can reverse a ruling made by his predecessor and assess deficiencies for all prior years for which the statute of limitations has not run, as well as penalties for failure to file returns, where the ruling on an organization's exempt status is subsequently found to be erroneous. The statute of limitations does not start running until a return was filed, deficiencies therefore may be assessed for all prior years for which an organization basing its exemption on an erroneous ruling has not filed any return.¹⁷

For the years beginning after 1942, most exempt corporations must file annual returns even though no tax need be paid. Even though they are merely information returns, their filing starts the statute of limitations running automatically, so that

¹⁶ Sec. 29.101-1.

¹⁷ Southern Maryland Agricultural Fair Ass'n., 40 BTA 549.

an adverse ruling in the future may find some years outlawed. Penalties will not be assessed for failure to file a return for those years which are still open.

For years beginning before 1951, for the limited purpose of determining the tax liability of organizations carrying on a trade or business but otherwise qualifying for exemption, the law itself treats the information return as a return sufficient to start the running of the statute of limitations.¹⁸

In the event of a change in activity by an exempt organization, all necessary and required information should immediately be submitted to the Commissioner so that a new ruling can be obtained confirming the continuance of the exempt status.

Where the Income Tax Unit has denied exemption, a review of the determination can be applied for to the Chief Counsel of the Bureau. This application will be granted if the Unit deems that there is justification for it.

The request for review must be accompanied by any additional statements of fact and arguments relied on by the applicant, and addressed to the Commissioner of Internal Revenue, Attention of Rules and Regulations Division, Income Tax Unit. Any statement of fact submitted must be sworn to by a principal officer of the organization.

Where Chief Counsel considers it necessary, an opportunity will be given the applicant for a hearing before his office. When an opinion is rendered by the Chief Counsel, the case will not be referred again to him without a clear showing of a substantial change in the form, purpose or activities of the organization.¹⁹

Where a claim for exemption is denied and the organization does not acquiesce in the Commissioner's decision, a notice of proposed assessment of tax is usually mailed to the organization. This decision by the Commissioner of tax due for the years involved must be made before an appeal can be taken to the Tax Court. A mere denial by the Commissioner of the organization's claim without a determination that a deficiency exists is not sufficient.²⁰

Within 90 days from the date of the mailing of the deficiency notice, a petition for review of the case may be filed with the Tax Court of the United States. Proof in support of the exemption claim may be submitted before the Tax Court even though

¹⁸ Sec. 302(b) of the 1950 Revenue Act.

¹⁹ *Mim.* 3537 (Revised CB 1937-1, 100).

²⁰ *S. M.* 2538, CB III-2, 286 (1924).

the necessary proof was not furnished to the Commissioner.²¹

With the exceptions listed below in this article, every organization which is exempt from taxation must file a return for each year beginning with 1942.²² The return must state the items of gross income, receipts, disbursements and any other information which the Commissioner may require. In addition, the 1950 Revenue Act requires charitable, scientific, educational, etc., organizations which must file these information returns also to furnish for years beginning after 1949 detailed information on their disbursements and accumulations. This is to enable the public to judge whether they actually perform the functions which made them tax-exempt.²³

The only exempt organizations which do not have to file are the following:

1. Religious organizations or organizations operated, supervised or controlled by or in connection with religious organizations.

2. Educational organizations which *normally* maintain a regular faculty and curriculum, and *normally* have a regularly organized body of pupils or students in attendance at the place where the educational activities are regularly carried on. Thus an educational organization did not have to file because war conditions forced a temporary discontinuance of normal activities.

3. Charitable organizations or organizations for the prevention of cruelty to children or animals, which are supported, in whole or in part, by contributions of the United States or political subdivisions, or which receive at least 50% of their income and receipts for the year from voluntary contributions by the general public. Contributions from a few contributors or donors or from persons or groups who are connected with or interested in the organization, such as founders, incorporators, shareholders, members, fiduciaries, officers, employees, etc., will not constitute contributions from the general public.²³ A tax exempt charitable organization is not relieved from filing information returns merely because it receives payment from the federal or state governments in connection with Workmen's Compensation, patients, etc. The reference to governmental funds contributed means contributions for which no special services are rendered.²⁴

²¹ Savings Feature of the Relief Dept. of B. & O. R. R. Co., 32 BTA 295 (A).

²² Sec. 6033(a), 1954 I. R. C.

²³ Sec. 29.101-2(h).

²⁴ I. T. 3710, CB 1945, 147.

4. Fraternal organizations. This refers to organizations exempt from tax solely because they are such. Certain labor organizations which might also qualify as such are not exempt from filing.

5. Organizations which are wholly owned corporations of the United States or its agencies or instrumentalities, or a wholly owned subsidiary of one of these organizations.²⁵

Any organization which claims to be exempt from filing must submit with and as a part of its affidavit or questionnaire, a statement of all the facts on which it bases its claim.²⁶

The fact that an organization is exempt from tax does not excuse it from filing information returns in regard to payments of \$600.00 or more, or from withholding requirements.

Every exempt organization required to file annual returns must keep permanent books of accounts and records, including inventories sufficient to show the information required in connection with the annual return.

The annual returns are to be filed on Form 990 (revised March 1951) with the collector of the district in which is located the principal place of business or principal office of the organization. The return is to be based on the established annual accounting period of the organization, or the calendar year, if there is no established accounting period. Religious and apostolic organizations file on Form 1065. For taxable years beginning after 1949, those charitable, educational, scientific, etc. organizations which must file information returns, file information return Form 990-A. This form requires more detailed information on the organization's use of its funds, both principal and income, for the particular purposes for which it was granted the exemption.²⁶

The return is due on or before the 15th day of the fifth full calendar month after the close of the annual accounting period,²⁷ for instance May 15th for calendar year organizations.

A central or parent organization must always file a separate annual return for itself, but it may file, in addition, one group return on Form 990 (revised March 1951) or Form 990-A, as the case may be, for two or more of its local organizations or chapters instead of the separate returns otherwise required for the local under oath, containing the information required on the group

²⁵ Sec. 29.101-2(h).

²⁶ Sec. 29.101-2(b); Sec. 6033 (1954) I. R. C.; Sec. 29.153-1.

²⁷ Sec. 29.101-2(g).

organizations. The return is based on the annual accounting period of the central organization, or the calendar year if the central organization has no established accounting period.

The local organizations included in the group return must be:

1. Chartered by, or affiliated or associated with, the central organization at the close of its year.
2. Subject to general supervision and examination by the central organization.
3. Exempt from tax under the same provision of law as the parent organization.

The group return may include only those local organizations which have authorized the central organization, in writing, to include them in the return. In addition, the central organization must have received statements of the local organizations' verified return. These records must be permanently retained by the parent organization. A schedule must be attached to the group return showing the name and address of each local organization included in the return and a similar list of those not included.²⁸

By using the group return, all of the income and disbursement items of a large number of affiliates may be lumped together. Therefore, they will not be required to reveal as much of their financial affairs as was originally anticipated.

"Exempt farmers" cooperatives have until the 15th day of the 9th month after the close of their taxable years to file returns (Form 990-C) and pay any tax due for taxable years beginning in 1952. This means September 15th for calendar year 1952 returns.

The normal due date is the 15th day of the 3rd month after the close of their year (March 15th for calendar year cooperatives).

Interest will run from the original payment date unless an advance payment is made by that date to the Director with whom a return will be filed. If the advance payment is made, interest will apply only on any difference between the advance payment and the actual tax shown when the return is filed.²⁹

If, because of a change in activity or method of operation, an organization loses its exempt status, it must file a corporation

²⁸ Sec. 29.101-2.

²⁹ Rev. Rul. 27, IRB 1953-5, 13; Treas. Rel. IR-043, 2/13/1953; Rev. Rul. 102, IRB 1953-12, 4.

income tax return showing amount of tax due. The transition from exempt to non-exempt status has no effect on the organization's accounting period. If the day on which the organization becomes a taxable entity does not coincide with the first day of its accounting year (whether calendar or fiscal year) the organization must file a return for a short taxable year which ends with its accounting period year.³⁰ The organization may not prorate its income over the twelve months of its accounting year and report as taxable income only the portion applicable to the period during which it was not exempt.

After the change in status, income which is derived from contracts issued or assets held while the organization was tax exempt must be included in taxable income.³¹

Labor, Agricultural or Horticultural Organizations are exempt from tax if they fulfill the following qualifications:

1. No part of the income may inure to the benefit of any member.
2. The organization must be educational or instructive in character.
3. It must have as its objective the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.³²

Despite their exemption on principle, these organizations are subject to taxation on their so-called "Supplement U Net Income," that is, on income derived from a trade or business unrelated to their main functions, or from certain leaseback transactions.

The following agricultural or horticultural organizations have been held *exempt*:

County fairs and like associations which have a quasi-public character and which are designed to encourage the development of better agricultural and horticultural products through a system of awards, and whose income is used exclusively to meet the necessary expenses of upkeep and operations.³³

Agricultural fair association organized as a corporation which derived income from admissions and concession fees, advertising

³⁰ *Royal Highlanders*, 1 T. C. 184(A), rev'd on other grounds, 138 F. (2d) 240.

³¹ See note 30 *supra*.

³² Sec. 29.101(1)-1.

³³ Sec. 29.101(1).

and the rental of farm grounds. No salaries were paid to officers and no dividends were declared although the articles of incorporation contained no prohibition against them.³⁴

Farmer's cooperative organization having no capital stock, supported by dues and fees of its members; its purposes being to educate the agricultural classes in scientific farming, etc., and to assist its members in cooperative buying and selling.³⁵

Exemption was denied to the following organizations:

Breed register associations.³⁶

Associations which hold periodical race meets, the profits from which may inure to shareholders.³⁷

Corporations engaged in growing agricultural or horticultural products for profit.³⁸

A corporation engaged solely in publishing a paper in the interests of organized labor, which contained no advertisements, the expense of the publication being borne by labor organizations, qualified as an exempt labor organization.³⁹ Also exempted was a corporation which owned and operated a "labor temple" containing offices, meeting halls, and auditorium, etc., for the use and occupancy of labor unions and councils and their members. All the shares of the corporation were owned by the unions and their members.⁴⁰ Where a corporation owned by a union afforded employment to union members, it was not exempt where all profits were paid to the union.⁴¹

In *Big Spring Cowboy Reunion v. Campbell*⁴² where an agricultural organization formed and founded as a non-profit enterprise for betterment of conditions and development of greater efficiency in farm and ranch activities and improvement of products was held to be an exempt organization. The fact that it was incorporated under general business provisions of the State (Texas) law was immaterial.

³⁴ I. T. 2325, CB V-2, 63 (1926).

³⁵ Farmers Union State Exchange, 30 BTA 1051(A).

³⁶ A. R. M. 79, CB 3, 235 (1920).

³⁷ Sec. 29.101(1).

³⁸ See note 37 supra.

³⁹ S. M. 2558, CB III-2, 207 (1924).

⁴⁰ Portland Cooperative Labor Temple Ass'n., 39 BTA 450(A).

⁴¹ O. D. 523, CB 2, 211 (1920).

⁴² D. C. Tex. 12/2/1952.

Fraternal Beneficiary Societies, Orders or Associations are exempt where they:

1. Operate under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system.⁴³ An association organized to hold title to property for exempt fraternal beneficiary orders and which provided funds for the purchase of the property and received the net income from it is exempt;⁴⁴ and

2. Provide for the payment of life, sick, accident or other benefits to the members of the society, order or association or their dependents.⁴⁵ Maintenance of a home for the care of old and infirm members of the order who are unable to earn a livelihood and for their dependents satisfies the benefit future requirement.⁴⁵ Organizations engaged in the encouragement of patriotism are not exempt.⁴⁶

Organizations which do not meet these requirements should not overlook the possibility of exemption as a social club.

In the case of *Fraternal Order of Citizens of America*⁴⁷ where the organization in which the members had no one common bond and which carried on no activities directed towards its stated purpose and which had only the one chapter was considered not to operate under the lodge system. Death benefits payable to only one class of members who could designate beneficiaries other than dependents did not constitute providing benefits to members or their dependents. Taxpayer did not qualify under either test. For exemption it must qualify under both.

Cemetery Companies are exempt if—

1. It is owned by and operated exclusively for the benefit of its owners who hold lots for *bona fide* burial purposes and not for resale, or

2. It is not operated for profit, or

3. It is chartered solely for burial purposes as a cemetery corporation, company or association and is not permitted by its charter to engage in any business not necessarily incident to that

⁴³ Sec. 101(3).

⁴⁴ S. M. 2164, CB III-2, 206 (1924).

⁴⁵ I. T. 3261, CB 1939-1, 122; I. T. 1516, CB I-2, 180 (1922).

⁴⁶ O. D. 508, CB 2, 207 (1920); Sec. 29.101(3)-1; *Western Funeral Benefit Ass'n. v. Hellmich*, 2 F. (2d) 367.

⁴⁷ 19 T. C. 240.

purpose, and no part of its net earnings inures to the benefit of any private shareholder or individual.⁴⁸

Religious, Charitable, Scientific, Literary and Educational Organizations and Community Chests.

Corporations, ordinary trusts,⁴⁹ community chests, funds or foundations,⁵⁰ whether created by contributions of the general public or of one individual,⁵¹ are exempt under this classification if they meet three requirements:

1. Are organized and operated exclusively for these purposes.

2. No part of its earnings inures to the benefit of a private shareholder or individual.

3. No substantial part of their activities may be devoted to carrying on propaganda or otherwise attempting to influence legislation.⁵²

In *Rev. and Mrs. Harold L. DuRosette*,⁵³ the tax on gain realized from the sale of church property, title to which was held by the pastor and his wife upon a verbal trust, was not taxable to the trustees personally. The facts showed a valid religious trust, though verbal.

In *Mabee Petroleum Corporation v. U. S.*⁵⁴ the Court of Appeals held that the payment of excessive salary to an individual will disqualify the corporation organized for charitable purposes.

⁴⁸ Sec. 29.101(5)-1; Sec. 101(5) I. T. 1881, CB II-2, 200 (1925); Forest Lawn Memorial Park Ass'n. Inc., 45 BTA 1091 (NA); Forest Lawn Memorial Park Ass'n. Inc., T. C. Memo Dkt. No. 2006, 8/20/1946; Sec. 29.101(5)-1; I. T. 1541, CB I-2, 182 (1922); *Com. v. Kensico Cemetery*, 96 F. (2d) 594; *West Laurel Hill Cemetery Co. v. McLaughlin*, 114 F. Supp. 63.

⁴⁹ *Fifty-Third Union Trust Co. (Schmidlapp Fund) v. Comm.*, 56 F. (2d) 767.

⁵⁰ Sec. 101(6).

⁵¹ *S. M. 1836*, CB III-1, 273 (1924); *Com. Battle Creek Inc.*, 126 F. (2d) 405; *G. C. M. 4805*, CB VII-2, 58 (1928); *George O. May*, 1 BTA 1220; *T. B. R. 33*, CB I, 199 (1919) 2937; CB XIV-2, 123 (1935); *I. T. 1906*, CB III-1, 270 (1924); *I. T. Kemper Military School v. Crutchley*, 274 Fed. 125, *Scholarship Endowment Foundation v. Nicholas*, 106 F. (2nd) 552, cert. den. 308 U. S. 623.

⁵² *Emerit Baker Inc.*, 40 BTA 555(A); *Com. v. Edward Orton, Jr. Ceramic Foundation*, 173 F. (2d) 483, affg. 9 T. C. 533; *Davenport Foundation*, T. C. Memo Dkt. No. 10427, 12/24/1947, aff'd. 170 F. (2d) 70; *Home Oil Mill v. Willingham*, 86 F. Supp. 525; *I. T. 3220*, CB 1938-2, 164; *Geological Institute of America*, 17 T. C. No. 199; *S. M. 1362*, CB 2, 152 (1920); *O. D. 704*, CB 3, 240 (1920); *G. C. M. 3830*, CB VII-1, 114 (1928).

⁵³ T. C. Memo Dkt. No. 28556, 4/23/1952.

⁵⁴ (CA-5) 4/17/1953.

The salary was paid to the former owner of the property owned by the taxpayer.

The Tax Court has held that a trust engaged in business is not exempt from tax on such income.⁵⁵

The Bureau has tentatively ruled that the American Bar Foundation qualifies as an exempt educational organization.⁵⁶

Family Foundations.

Congress has fully approved the family foundation despite many pleas to outlaw it. It has set up some new rules, reasonable rules, easy rules to follow.

Anyone can establish a family foundation.

Anyone with large income or capital will be able to accumulate significantly more dollars in a foundation than in a corporation, in a trust, or in a personal portfolio.

Foundation work is deemed socially desirable, therefore foundations get enormous tax privileges. These make it possible to conserve assets and to build up funds more easily than in a profit-making corporation.

Congress has established rules against diversion of funds. If they are violated, the foundation loses its tax privileges. These rules allow:

1. To borrow, if the terms are in line with banking practice.
2. To buy or sell assets, if the terms are kept strictly in line with real values. Every transaction should be backed up by qualified appraisals by other bids or offers.

Business income is now taxed to the foundation. So are rent from leases over five years to the extent that the foundation incurred debt to acquire rental property. But other rents, dividends, interest, royalties, capital gains, are received tax free.

The new law provides that a foundation should not own or operate a business. If it does, it must pay a tax on its business income. Its income should consist only of investment revenue—interest, dividends, royalties, rents (except long-term lease-back rent acquired or improved with borrowed funds). If it has in-

⁵⁵ Joan Doaz, 18 T. C. No. 54; Arthur Jordan Foundation, T. C. Memo Dkt. No. 31263, 2/10/1953; Ralph H. Eaton Foundation, T. C. Memo Dkt. No. 30985, 2/27/1953.

⁵⁶ Letter to Foundation, 12/24/1952, Sec. 301(c)(1) of the Revenue Act of 1950 amended Sec. 101 of the Code; Reg. 111, Sec. 29.101(6)-1 was amended by T. D. 5928, 1952 IRB-19, p. 6.

come from a business or from the prohibited long-term lease-back operations, that is taxed. So we may lose the advantage of the tax exempt income on these items to the foundation. If the foundation owns a subsidiary business company, it is taxed as a regular business operation.

But we get full tax exemption for the foundation—*get a full tax credit for gifts to it*—if its income is of the investment type . . . if its disbursements are reasonably close to its receipts (it does not have to disburse all it received).

Taxpayer nor his family are prohibited from dealing with a foundation. But he cannot engage in transactions with his foundation unless they will improve its income or asset position. If it meets this test, taxpayer can benefit by improving his liquidity, getting himself financed, realizing personal capital gains.

The prohibitions are simple, *easy to follow*. The foundation cannot have the right to give the family (out of any income or principal) any of these advantages.

1. Lending to them, without adequate security, or at an unreasonable rate of interest.

2. Paying them compensation over a reasonable allowance for personal services actually rendered.

3. Making any services available to them on a preferential basis.

4. Buying from them or selling to them substantial securities or property for less than an adequate consideration.

5. Engaging in any other transaction with them resulting in a substantial diversion of income or principal.

If we follow these simple rules, the tax exempt foundation can:

1. Retain much of the benefits of wealth—even though it has been given away.

2. Be used to protect capital from tax erosion, the money lost by persons with high incomes.

3. Have the donor or his family administer the foundation. You don't have to bring in strangers who have no personal stake in the family business. So a family can vote the stock held by the foundation, setting all its business policies on compensation, dividends, reorganizations.

4. Retain funds in the foundation. All the law requires is that the foundation pay out what is reasonable in order to carry its purposes. It can invest its money if that does not jeopardize the interests of the religious, charitable, scientific, etc., beneficiaries.

The new law requires honest dealing between the foundation and the donor—both recognizing the purpose for which it was created. The government will check that annually in a new way—securing from all foundations reports on their income, expenses, accumulations and balance sheets.

With present day income and estate tax rates, the foundation seems to be the last method available to permit diversion of capital to sources of one's own choosing. It is one of the few processes left by which we can now begin to accomplish the job previously completed by capital built up by income or property appreciation.

What can be accomplished by creating a foundation?

1. Keep control of wealth.

2. Can keep for the donor many attributes of wealth by many means.

(a) Designating the administrative management of the foundation.

(b) Control over its investments.

(c) Appointing relatives as directors of foundation.

(d) Foundation's assets can be used to borrow money to buy other property that does not jeopardize its purposes. Thus, foundation funds can be enhanced from the capitalization of its tax exemption.

3. The foundation can keep income in the family.

4. Family foundations can aid employees of the donor's business.

5. Foundations may be the method of insuring that funds will be available for use in new ventures in business.

6. We can avoid income from property while it is slowly being given to a foundation by a combination of a trust and the charitable foundation.

7. We can get the 20% charity deduction in other ways:

(a) By giving away appreciated property to the foundation, we escape a tax on the realization of a gain.

(b) We can give funds to a foundation to get charitable deduction currently in our most advantageous tax year.

(c) Very often local personal and real property taxes can be avoided.

(d) We can avoid speculative profits.

(e) We can give away valuable "frozen assets," white elephant estates, residences, valuable works of art, and collections of all arts.

Business Income of Certain Tax-Exempt Organizations.

When it came to the attention of the Treasury Department that certain educational and other organizations were engaged in business operations which had no relation to their exempt non-business purpose, an attempt was made to deny the benefits of tax exemption to such organizations. This approach was not sustained by the Courts, save in isolated cases.⁵⁷ Some decisions took a broad view in construing the exemption provision, particularly by interpreting an early Supreme Court decision⁵⁸ as meaning that the destination and not the source of income is the test to be used in deciding the question of exemption. Some cases have also held that a business organization which conducts no exempt activities itself may receive tax exemption if the ultimate recipient of its income is an exempt organization.⁵⁹

In recent years this practice has spread, particularly among charitable and educational institutions and a wide variety of business activities have been engaged in by such organizations. Since under the Code many organizations were not required to file information returns, the data available to the Department did not disclose all the business activities in which such organizations participated.

The Department therefore recommended that the unrelated business activities of charitable and educational organizations, business leagues, labor unions and social clubs be subject to tax at the ordinary corporate rate. This proposal was presented to Congress in 1942. It was rejected. Since that time the abuse has spread.

⁵⁷ *Kriesien v. U. S.*, 99 F. Supp. 873 (D. C. Ore., June 15, 1951); *C. F. Mueller Co.*, 14 T. C. 922; 190 F. (2d) 120 (CA 3d, June 20, 1951); *Joseph B. Eastman Corp.*, 16 T. C. 1502; *Jack Little Foundation for Aid for the Deaf v. Jones*, 102 F. Supp. 326 (D. C. Okla., Dec. 10, 1951).

⁵⁸ *Trinidad v. Sagrada Orden*, 263 U. S. 578 (1924).

⁵⁹ *Roche's Beach, Inc. v. Comm.*, 96 F. (2d) 776 (CA 2nd. 1938).

Finally, in the Revenue Act of 1950 the recommendation was enacted into the Code. In analyzing the provisions designed to cope with the abuses disclosed at the hearings on the Act, it is good to bear in mind that "the problem at which the tax on unrelated business income is directed is primarily that of unfair competition."⁶⁰ The tax exempt status of eleemosynary institutions enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes. In a number of instances, some of these organizations have used their tax exemptions to purchase a business. They acquired commercial ventures with little or no investment on their own part and paid for it in installments out of subsequent earnings—a procedure which usually could not be followed if the business were taxable.

Title III of the Revenue Act of 1950 changed the treatment of the income of certain tax-exempt organizations and trusts, and the deduction for gifts and bequests to such organizations and trusts. This title is divided into 4 parts:

1. Taxation of business income of certain tax-exempt organizations.
2. Charitable and similar deductions of trusts not exempt from taxation.
3. Loss of exemption under Section 101 (6) of the Code and disallowance of certain gifts and bequests.
4. Information to be made available to the public.

Since the existing Supplement U of the Code is obsolete, the new provisions were inserted instead of the present provisions of Supplement U and were numbered as Sections 421 through 424 of the Code. For convenience of reference, the tax will be referred to as the "Supplement U Tax."

The Supplement U Tax⁶¹ is imposed upon labor, agricultural and horticultural organizations exempt under Section 101 (1) of the Code, charitable, scientific, literary, educational, religious organizations (other than a church, a convention or association of churches), and organizations for the prevention of cruelty to children or animals, exempt under Section 101 (6) of the Code,

⁶⁰ House Rep. No. 2319, 81st Cong. 2nd Sess., p. 56 and Sen. Rep. No. 2375, 81st Cong. 2nd Sess., p. 28.

⁶¹ Sec. 421 of the Code. This amendment applicable only with respect to taxable years beginning after December 31, 1950.

business leagues, chambers of commerce, real estate boards or boards of trade, exempt under Section 101 (7) of the Code; and corporations described in Section 101 (14), organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to any of the above listed exempt organizations which themselves are subject to the Supplement U Tax, or to a church or a convention or association of churches.

While churches and associations or conventions of churches, such as the Southern Baptist Convention, are exempt from the Supplement U Tax, religious organizations are subject to such tax even though organized under church auspices. This is also true of organizations with charitable and educational purposes which are organized under church auspices. Likewise, a Section 101 (14) corporation holding property for a church, or a convention or association of churches would be subject to the Supplement U Tax.

Any trust which would be subject to the provisions of Supplement E of the Code if it were not exempt from taxation by reason of Section 101 (6) of the Code is also subject to Supplement U Tax.⁶²

The Supplement U Tax as originally adopted did not apply to state colleges and universities, since such organizations were not exempt under Section 101 of the Code. The Revenue Act of 1951 subjected colleges and universities run by governments to similar tax treatment under Supplement U with respect to their unrelated business activities as was provided in the case of private colleges and universities exempt under Section 101 (6) of the Code. To accomplish this result Section 339 (a) of the Revenue Act of 1951 amended Section 421 (b) (1) of the Code effective with respect to taxable years beginning after December 31, 1951 was enacted.

⁶² Sec. 42 (b) (2) of the Code.